Subcommittee on Consumer Affairs, Foreign Commerce, and Tourism
Senate Committee on Commerce, Science, and Transportation

Hearing on Corporate Responsibility and Ways to Protect Consumers and Investors
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Testimony of Nell Minow
Editor, The Corporate Library

Mr. Chairman and members of the committee,

I want to begin by thanking you for inviting me to appear today. American investors, consumers, and employees have been deeply shaken by the stories of corporate corruption, and it has been very gratifying to see the Senate and Congress move so quickly to respond.

My father, asked to speak to a group of new young lawyers at his firm, told them that the most important goal was to get the client to trust you. One young man asked him how to do that, and my father responded, "Well, you can start by being trustworthy."

This is a lesson that our corporate leaders must learn. In a way, we have all been enablers for bad behavior by corporate managers and directors, rewarding them at a level unprecedented since they used to give kings their weight in gold. Unfortunately, like that thankfully outdated form of compensation, ours have not provided optimal incentives, and managers have therefore opted for short-term self-dealing rather than long-term, sustainable growth in shareholder value.

The complicating factor here is that there have been so many failures by so many different entities that it is a challenge to provide an effective and coordinated response.

I want to speak briefly about five problem areas and the place most likely to provide some improvement. The one area I do not plan to address is accounts and accounting firms, because I believe that it has been thoroughly covered by the pending legislation. I will be happy to answer questions about that issue as well as the others I am raising at the end of my testimony.

1. <u>Stock options and pay disclosure</u>

We all have to take a moment to accept some responsibility for the problem here. Stock options would not have gotten so out of hand if not for our last attempt to address these problems, back when CEO pay was grabbing headlines in 1991. The result was a classic lesson in the law of unintended consequences. Congress amended the tax code to put a ceiling on deductibility of CEO cash compensation at $1 million, but no limit on performance-based pay, meaning options. The result: all base pay got raised to $1 million and the average option grant went from the thousands to the millions. The stock doesn't have to do very well for 2 million options to be worth a lot of money. Seventy percent of option gains are attributable to the overall market, not the performance of an individual company, much less the individual recipient of the options. And the tax code provides enormous obstacles to the most legitimate option grants, indexed options, which would make sure that the executives are rewarded only for their company's performance.

To make things worse, the SEC changed the rules to permit "cashless exercise" of options instead of encouraging or requiring executives to hold on to the shares.

I do not believe Congress should get involved in setting accounting standards. In fact, Congress was the problem the last time this came up, with an unprecedented interference with FASB's attempt to require that option grants be expensed. FASB wants to do the right thing, and has additional support from the investor community and the International Accounting Standards Board. All we need to do is get out of their way and protect FASB from political interference.

What Congress should do is revisit the tax code to redefine performance-based pay. Our recent report compares US option grants, which are generally not linked to performance, to those in the UK. Our tax code should encourage compensation plans that truly link pay to long-term performance and not short-term books-cooking.

The SEC should rescind its rule and prohibit cashless exercise of stock options.

Finally, the SEC should go back to its original disclosure requirement for the top five highest paid executives. That rule was changed to apply only to "officers," creating a huge loophole that permits companies to evade disclosure of crucial information.

2. <u>Enforcement of existing laws</u>

The SEC under the previous administration and the one before that has done a poor job of coordinating with the Justice Department and as a result, there have been far too few criminal prosecutions for securities fraud. Oversight committees should insist that the SEC and DOJ work closely together to eliminate petty bureaucratic differences and present to Congress a meaningful plan for enforcing the laws already on the books and making it so painful to violate securities laws that the bad guys will reconsider and try something a little less risky.

It would help a lot if we had a full set of SEC Commissioners, and now would be a good time to put one or two investor advocates on the commission, instead of the usual suspects who come from the other side. One action has already been thrown out because two of the three sitting SEC commissioners had conflicts. Let's get five commissioners on board, with backgrounds with enough diversity that we will not have that problem again.

3. Boards of directors

The greatest failure at Enron, WorldCom, Adelphia, Global Crossing, and Tyco was not the failure of the accountants, analysts, or regulators. It was the boards of directors. We need to think carefully about a system that takes capable, honorable, experienced people and puts them into a situation that does not allow them to do a good job. What is it about the atmosphere of the boardroom that causes the most distinguished people in America to lose half of their IQ points and all of their courage?

Unfortunately, the federal government plays more of a role in a local elementary school than it does in the boardroom. Our tradition is to leave that role to the states, and that means Delaware, which long ago won the race to the bottom by providing the most management - and director-friendly legislature and court system in the country. Now, of course, Bermuda beckons, and I hope Congress will cut off that route before any other companies escape American law entirely.

But if we are to leave it to state law, we must create a race to the top by allowing shareholders to choose the state of incorporation. Every five years, shareholders should be allowed to submit a proposal to change the state of incorporation. That would encourage experimentation, innovation, and, especially, consideration of shareholder rights.

The SEC should also require additional disclosure, including all relationships between directors and officers of the company. And we at The Corporate Library are hoping that our new board effectiveness rating will someday become as important a part of the risk assessment of an investment as the company's credit rating and performance history.

4. The Exchanges

The Self-Regulatory Organization structure has permitted the foxes to guard the chicken coop. No wonder the chickens are scared. The exchanges usually act as though they work for the issuers. In a rare exception, the NYSE has produced a truly outstanding proposal for enhancing its listing standards. NASDAQ, on the other hand, has produced a proposal most charitably described as disappointing. If the NYSE is not going to run the risk of scaring its listed companies over to the more forgiving confines of the NASDAQ, the SEC has to have authority to require it to match the NYSE's standards.

5. The shareholders

All of the reform proposals currently focus on what I call the "supply side" of corporate governance – what companies, directors, and auditors must do. None of this will work unless we also focus on the "demand side," what shareholders can and must do.

Institutional shareholders manage the largest accumulation of investment capital ever assembled. They include pension funds, mutual funds, foundations, endowments, and others. There was a lot of information about the potential problems at Enron, Global Crossing, Adelphia, and WorldCom. Why didn't they act on it?

In the hotly contested merger at Hewlett Packard and Compaq this year, every vote counted. One of HP's largest shareholders, Deutsche Asset Management, voted against the merger. Then they got a million dollar fee from the company. Then they changed their vote. Then the merger passed.

This was challenged in the Delaware courts. But the Delaware court upheld it, partly because, as I said earlier, they cater to management because they want to keep that nice, clean income from the companies "domiciled" there. But the other reason was that the challenge was to HP, and whether what they did was fair to HP shareholders. Putting that issue aside, who is going to challenge it from the Deutsche Asset Management side, and ask whether what they did was fair to the people whose money they manage, the people who trust them to buy, sell and vote stock based on what is right for them, regardless of what fees they generate for themselves?

Where are the SEC and DOL? They both have the right to investigate the exercise of proxy votes by institutional fiduciaries. But despite extensive evidence of the deepest level of corruption and mismanagement, there has never been a single enforcement action brought because of the failure to exercise shareholder rights, including proxy voting, in the interests of investors or plan participants.

Both agencies should issue prompt, clear, and unequivocal statements to the institutional investors under their jurisdiction calling for the strictest possible controls to ensure that proxy votes are cast with integrity.

Institutional investors should have to disclose their proxy voting policies and any votes inconsistent with those policies. They should log every attempt to get them to change a vote.

Here is why these issues are suddenly so striking: The rising tide lifted all the boats and the boom market hid a multitude of shortcuts and fudges. But as the tide went out, boats foundered on the rocks, and some of the rocks fell over, revealing some nasty creatures underneath.

One thing that Senators understand better than anyone else is the importance of a system of checks and balances to guide the exercise of power and protect the citizens from abuse. The corporate system of checks and balances has been allowed to all but tip over completely. The failures at what I still believe are the edges of the system have taught us some important lessons about the obstacles to market efficiency and about what we need to do to make sure that the checks and balances are restored. I hope to be a constructive voice in that process.

Thank you again, and I welcome your questions.

The Corporate Library
1200 G Street, NW – Suite 800, Washington, DC 20005
T: 202-434-8723 F: 202-783-3316 E-mail: nminow@thecorporatelibrary.com